No. 20,472

# In the United States Court of Appeals for the Ninth Circuit

RUSSELL L. IRISH, d/b/a RUSSELL L. IRISH INVESTMENTS, and RUSSELL LAWSON IRISH, PETITIONERS,

*v.*

SECURITIES AND EXCHANGE COMMISSION, RESPONDENT.

## BRIEF FOR RESPONDENT SECURITIES AND EXCHANGE COMMISSION


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## In the United States Court of Appeals for the Ninth Circuit

No. 20,472

Russell L. Irish, d/b/a Russell L. Irish Investments, and Russell Lawson Irish, Petitioners,

*v.*

Securities and Exchange Commission, Respondent.

## BRIEF FOR RESPONDENT SECURITIES AND EXCHANGE COMMISSION

### JURISDICTIONAL STATEMENT

This is a petition to review an order (R. 1421-30)[1] of the Securities and Exchange Commission entered August 27, 1965, pursuant to Sections 15(b) and 15A of the Securities Exchange Act of 1934, 15 U.S.C. 78*o*(b) and 78*o*-3, revoking the registration as a broker and dealer in securities of Russell L. Irish, d/b/a Russell L. Irish Investments ("Mr. Irish"), expelling him from membership in the National Association of Securities Dealers, Inc. ("NASD"), and naming Russell Lawson Irish, Mr. Irish's son whom he employs as a salesman, as a cause of that revocation and expulsion (R. 1421-1430).[2] On October 21, 1965, Mr. Irish and Russell

[1] References to pages of the reproduced record are cited as "R. —" and to pages in petitioners' brief as "Br. —".

[2] Russell Lawson Irish is also a petitioner and joins in the contentions made by his father. No additional argument that he personally did not violate the antifraud provisions or was not a cause of the sanction is offered on his behalf.

Lawson Irish filed a petition to review. Jurisdiction of this Court is based on Section 25(a) of the Securities Exchange Act, 15 U.S.C. 78y(a).

## COUNTERSTATEMENT OF THE CASE

Since 1942 Mr. Irish has been registered with the Commission pursuant to Section 15(b) of the Securities Exchange Act of 1934. He is a member of the NASD, and has "engaged exclusively in the sale of mutual fund shares for many years" (R. 1422, 1426). The order under review was entered in private proceedings instituted in March 1959 by the Commission pursuant to Section 15(b) and 15A of the Securities Exchange Act.

The Commission found that antifraud provisions of the federal securities laws [3] were violated by petitioners in that petitioners churned customers' accounts by "switching" customers from one mutual fund to another;[4] in that petitioners purchased mutual fund shares for customers in amounts just under minimum "break

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[3] Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a); Sections 10(b) and 15(c)(1) of the Securities Exchange Act, 15 U.S.C. 78j(b) and 78*o*(c)(1), and Rules 10b-5 and 15c1-2 thereunder, 17 CFR 240.10b-5 and 15 c1-2.

[4] "Switching" is the term usually applied to the churning of customers' accounts where mutual fund shares are involved. For a description of "churning" see *Norris & Hirshberg, Inc.* v. *Securities and Exchange Commission*, 177 F. 2d 228, 232 (C.A.D.C., 1949). See also *Securities and Exchange Commission's Report of Special Study of Securities Markets*, H.R. Doc. 95, 88th Cong., 1st Sess. Pt. 4 at p. 151 (1963).

points";[5] and in that Mr. Irish effected sales of mutual fund shares to two customers at prices in excess of the public offering price (R. 1422-1427). Petitioners do not seriously contest the facts as found by the Commission. Their specific contentions as to the facts deal only with the weight given to the evidence (Br. 28-33), although they state that the findings of fact are not supported by the evidence (Br. 28).

*Churning.*

The Commission analyzed the accounts of Mr. Irish's nine largest customers over a period of approximately five years[6] and found that Mr. Irish, "contrary to the customers' best interest and for his own gain, induced purchases and redemptions of mutual fund shares in the accounts of customers, which were excessive in size and frequency in the light of the character of such accounts" (R. 1422). The Commission's analysis showed that Mr. Irish "followed a policy of recommending to customers that they redeem the shares of one mutual fund and use the proceeds to buy those of

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[5] "Break points" are points at which quantity discounts as to sales load are made available to purchasers of mutual fund shares. For example, in one of the funds here involved on purchases of shares from $1 to $24,999 the purchaser pays an 8½% sales charge, which includes a commission to the dealer of 6%; on purchases from $25,000 to $49,999 the sales charge is 5½% and the commission is reduced to 4%. Prospectus of National Securities Series of July 27, 1953, Commission Public File No. 2-10347-1.

[6] The period analyzed was from September 28, 1953 through October 31, 1958. The proceedings had been instituted March 19, 1959. The Commission noted: "The order for proceedings charged . . . Mr. Irish with violations beginning in 1943, but evidence was introduced only for this shorter period" (R. 1422, n. 2).

another fund, or shift from one series to another series of the same mutual fund, which transactions required the payment of a new sales commission'' (R. 1423). Mr. Irish's ''policy of switching his customers from one mutual fund security to another'', the Commission found, ''was highly profitable to himself and detrimental to his customers'' and ''accounted for $65,593 of . . . [petitioners'] commissions'' from the nine accounts ''during the period in question.'' ''In every case'', the Commission also found, ''the switching of investments resulted in a reduction in the profits which the customer otherwise would have made.'' (R. 1424.) The Commission further stated that the ''sales commission or load paid by these customers on the purchase of mutual fund shares was considerably higher than they would normally pay on the purchase of other securities; the commissions often ran as high as 8¾% of the offering price and included a dealer commission for . . . [Mr. Irish] of as much as 6% of the offering price.'' (R. 1425.)

Of the nine customers whose accounts were studied, six were farmers or retired farmers, one was a widow, whose sole source of income at the time she testified was her investments, one was a physician and one was an accountant (R. 1422-1423, 477). The Commission found that these customers generally followed Mr. Irish's recommendations. The Commission rejected petitioners' contention that these customers were ''sophisticated investors,'' finding, indeed, that the evidence tended to establish the contrary (R. 1423).

O. George Wagnild, one of the farmer customers, the Commission found, effected 17 purchases of mutual

fund shares, of which 11 occurred in switches. By comparing the value of his account as of October 1958, together with dividend and capital gains distributions since 1953, with what the corresponding total would have been had Mr. Irish not switched him from the funds he held on the earlier date, the Commission found it would have been $13,805 greater. The Commission found that of the total commissions of $7,365 from transactions in Mr. Wagnild's account, the sum of $6,300 was attributable to switches (R. 1423, 1424).

On a similar comparison made of the account of Maurice D. Prince, the accountant customer, the Commission found that he purchased $214,459 of mutual fund shares in 16 transactions, of which 14 occurred in switches.[7] The market value of Mr. Prince's interest in mutual fund shares (including dividend and capital gains distributions) was $32,162 less than it would have been had there been no switches. Of the total commissions of $7,488 received by petitioners from transactions in Mr. Prince's account during the period studied, the Commission found that the sum of $7,012 was attributable to switches (R. 1423, 1424).

The Commission found that the other seven of the nine customers whose accounts were studied would also have been substantially better off had there been no switches and that Mr. Irish's commissions from those accounts attributable to switching ranged from $1,468 to $11,237 (R. 1424-1425). As to these customers, the

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[7] While the Commission studied all accounts for the period September 1953 through October 1958, this particular account was not sufficiently active from January 1957 to October 1958 to warrant any conclusions with respect to that period (R. 1424, n. 7).

Commission noted in addition that Dr. Milo Harris, the physician customer, effected 21 purchases totalling \$344,111, of which 12 occurred in switches; that Mrs. Therese W. Benedict, the widow, effected during the 27 months that her account was active 6 purchases of \$46,588, of which 4 were in switches; that Harry A. Boger, one of the farmer customers, effected 27 purchases totalling \$395,226, of which 19 occurred in switches; and that the remaining four customers effected, respectively, 16, 20, 33 and 35 purchases, of which 8, 8, 14 and 16 were in switches (R. 1423).

The Commission also found with respect to the nine accounts studied: "Not only was there excessive switching between mutual funds, but switches were in many instances effected after the first fund had been held in the customer's account for a relatively brief period of time" (R. 1423). It found that 37% of mutual fund shares purchased had been held less than a year; 29% between one and two years; about 28% between two and three years; and only 6% had been held for more than three years (R. 1423).

In addition, the analysis of the nine accounts during the five-year period studied showed an "over-all pattern of selling after relatively short periods of retention in the customers' accounts" (R. 1424). The Commission found that "of approximately \$2,692,000 in mutual fund shares purchased from . . . [Mr. Irish] in 195 transactions, about \$959,000 or 36%, acquired in 55 transactions, were resold between one and two years; about \$194,000 or 7%, acquired in 19 transactions, were resold between two and three years; and about \$22,000 or 1%, acquired in 8 transactions, were resold after three years" (R. 1424).

*Failure to Disclose Minimum Break Points.*

The Commission found that Mr. Irish had defrauded customers in selling them mutual fund shares without adequate disclosure of minimum break points which, if they had been observed, would have reduced his commission charges to them. Thus the Commission found that sales were effected in March 1951 to Evan I. Evans and in October 1952 to Harry N. Boger, both farmer customers, in amounts of $23,661 and $24,000, respectively, when the break point in each case was $25,000. It appeared that both customers were financially able to make the small additional investments needed to obtain the benefit of break point financing. The Commission found that "had such additional purchases been effected [Mr. Evans and Mr. Boger] would have saved a total of $1,176 in sales charges, and [Mr. Irish's] commissions would have been reduced by a total of $609" (R. 1427).

This was the second time Mr. Evans received this type of treatment. Two sales were made to him, one on August 3 and another on August 23, 1950, of a total of $30,820 of shares of a single mutual fund, with each purchase amounting to less than the $25,000 break point. If these two purchases had been combined, Mr. Evans' sales load would have been reduced by more than $900, but Mr. Irish's commissions would have also been reduced—by more than $600 (R. 1427).

Russell Lawson Irish also followed this practice. On January 4, 1951, he sold shares of a mutual fund to Mr. Prince in the amount of $16,607, and a week later sold him $5,272 in the same fund. The Commission found that had Mr. Prince "combined the purchases and invested an additional $3,121 in the fund to reach the $25,000 break point, he would have saved

$750 in sales load and [petitioners'] commissions would have been reduced by $500" (R. 1427).

On June 7, 1954 Mr. Irish sold $19,340 of one series of a mutual fund to Harry A. Boger, another of the farmer customers and the father of Harry N. Boger, and two days later sold him $9,744 of two additional series of that fund. If these sales had been made at the same time Harry A. Boger would have saved $727 in sales charges and Mr. Irish's commissions would have been decreased by more than $400. On January 7, 1955 Mr. Irish also sold $16,538 of shares of another mutual fund to Harry A. Boger and at the same time $10,779 of shares of the same fund to Harry N. Boger. Under the terms of the prospectus of that fund purchases by members of immediate families could have been combined, which would have made the total amount exceed the break point, thereby causing a saving to the father and son of sales charges of $400 and causing a reduction of about $320 in commissions (R. 1427).

*Sales at Prices above Offering Price*

The Commission also found that Mr. Irish had sold to Louis E. Alboucq, another of his farmer customers, over $28,000 of two series of a mutual fund and to Evan I. Evans over $27,000 of the same two series. Under the terms of the mutual fund's prospectus, where the combined purchases of the customers in any series of the fund exceeded $25,000, the sales commission was to be reduced from 8½ to 6%. Mr. Irish nevertheless charged Mr. Alboucq and Mr. Evans the higher commission, resulting in an overpayment by them of some

$1,300 and the receipt by Mr. Irish of more than $800 in commissions to which he was not entitled (R. 1426).[8]

*The Delay in the Proceeding.*

Based on the foregoing, both the Commission (R. 1426, 1427) and the hearing examiner (R. 1392) concluded that Mr. Irish willfully violated the antifraud provisions of the securities laws (see p. 2, *infra*). The Commission, however, disagreed with the hearing examiner, who, notwithstanding the above findings of serious violations of the antifraud provisions, concluded that it was not in the public interest to revoke Mr. Irish's registration "because of the length of time that elapsed since the hearings were closed in September 1959, and the 'presumption,' which he considered to exist in the absence of information in the record to the contrary, that . . . [Mr. Irish's] conduct had been good during the interval" (R. 1428). The Commission held that Mr. Irish was not entitled to this presumption since the record was silent as to any such conduct, since the very nature of the violations found precluded such a presumption, and since similar and additional violations by Mr. Irish had been found in an earlier proceeding (R. 1429). The proceeding to which the Commission referred had been instituted before the NASD in January 1955.[9] The Commission noted that even after the affirmance of the NASD's decision by

[8] While Mr. Irish advised these two customers and the Commission that he would refund the excess commissions, the payment is not to be made until the completion of these proceedings (R. 1426, n. 13).

[9] The proceeding involved the accounts of 12 customers for the period 1943 to 1954, apparently including seven of the customers

that self-regulatory body's Board of Governors in October 1955, Mr. Irish continued his switching activities (R. 1429).

The Commission, in considering the question of delays in the proceeding, found that in view of the fact that the proceeding had been private, petitioners were not prejudiced by the lapse of time. It also found that petitioners had contributed to the delay and "had failed to take any steps to expedite" the proceeding. "[I]n light of the seriousness of the violations found", the Commission concluded that dismissal was not warranted and that "the public interest require[d] the imposition of a sanction" (R. 1429). This was the second time the Commission considered the question of delay in these proceedings. On December 12, 1963, the Commission had denied petitioners' motion for a permanent stay or a dismissal of the proceeding, noting, *inter alia*, that "no proof of financial hardship resulting from the delay [had] been offered by [petitioners]" (R. 1162). Petitioners sought review in this Court of that order and this Court dismissed the petition to review.[10]

In the decision under review the Commission "care-

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involved in the instant proceeding (Dr. Harris, Mr. Prince, Mrs. Benedict, and four of the farmer-customers). Mr. Irish was suspended from the NASD for 15 days and fined $3,000. He did not seek review by the Commission of the NASD's decision (R. 1429).

Petitioners were also the subjects of a later NASD disciplinary proceeding (see pages 28-30, *infra*), but this was not a basis for the Commission's determination that there was no presumption of good conduct.

[10] *Irish* v. *Securities and Exchange Commission* (No. 19,095, March 30, 1964).

fully reviewed'' the hearing examiner's recommendation and its own previous ruling (R. 1429).[11] At the close of the evidentiary hearing, held in Spokane, Washington, from September 21 through September 24, 1959, it had been stipulated that there would be included in the record depositions and interrogatories of certain witnesses who were then unavailable and whose testimony was desired by one or both of the parties (R. 283, 319). The last of these depositions was not filed until April 1961 (R. 1428). Prior to the completion of the taking of the depositions, counsel for petitioners on March 1, 1961 had suggested to the Commission's Seattle Regional Office ''that possibly some stipulation be worked out to windup the instant case'' (R. 1138). While there were conversations from time to time between petitioners' counsel and counsel for the Commission attached to the Commission's Seattle Regional Office, it was not until August 1962, when the Chief Enforcement Attorney of the Commission's Trading and Markets Division in Washington, D. C. went to Seattle to meet with Mr. Irish and his counsel that a definitive proposed settlement was discussed (R. 1136-1142). After several meetings and subsequent correspondence settlement efforts failed (R. 1148-1151).

Subsequent delay appears to have resulted in part from the preparation of supplementary analyses of the accounts of petitioners' customers. At the hearings,

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[11] The Commission included two members, Commissioners Budge and Wheat, who had been appointed since the previous ruling.

petitioners had objected to the introduction into evidence of the Commission's analyses of the customers' accounts on the ground that they were incomplete because they did not go beyond December 31, 1956. The hearing examiner at that time ruled that petitioners could prepare supplementary exhibits to bring the analyses through October 31, 1958, or the Division could submit such supplementary analyses (R. 221). After settlement negotiations had broken down, the Division commenced the preparation of the supplementary analyses. When these were submitted to petitioners' counsel he failed to comment thereon until called by a representative of the Division to determine petitioners' position (R. 1115-1116, 1160, 1428). Counsel stated that he intended to make objections to the introduction of the supplementary analyses, and in a letter dated July 30, 1963, confirming the telephone conversation, he stated that depositions and interrogatories "would still have to be admitted in evidence and, at that point, that proposed findings and conclusions could be made on behalf of the Commission and on behalf of the Irishes" (R. 1156). On August 8, 1963, the Division forwarded to counsel for petitioners a formal applicaion for the introduction of the analyses into evidence and again, since counsel for petitioners did not respond for over a month, he was called by a representative of the Division (R. 1160, 1115, 1428). During this conversation counsel for petitioners stated that he would not stipulate to the introduction of the documents (R. 1116). By letter dated September 13, 1963, counsel for petitioners confirmed this telephone conversation and stated that petitioners intended to move to dismiss

the proceeding "in the next several days" (R. 1117).

The Division moved (1) to reconvene the hearing for the limited purpose of introducing the analyses into the record and (2) to have the hearing examiner prescribe a time schedule for the filing of proposed findings and briefs. The Division's motion was denied by the hearing examiner on October 23, 1963, on the ground of laches and lack of due process. The Division appealed to the Commission, and petitioners, on October 29, 1963 (R. 1087), for the first time moved to dismiss the proceeding (R. 1161, 1428).[12] By order dated December 12, 1963, the Commission overruled its hearing examiner, denied petitioners' motion to dismiss the charges, determined that the proceeding be deemed closed, and directed that, as preparatory steps to the filing of a recommended decision by the hearing examiner, the parties should file proposed findings and supporting briefs (R. 1162). The Commission found that following the evidentiary hearing, in April 1961, neither the staff nor the petitioners had ever requested the hearing examiner to schedule the filing of proposed findings and briefs.

The Division's proposed findings and brief were filed on January 13, 1964 (R. 1163). Petitioners sought review in this Court on January 18, 1964. On February 10, 1964 this Court denied petitioners' motion to stay the administrative proceedings pending review. On

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[12] The Division did not in its application for review of the hearing examiner's refusal to schedule proposed findings of fact and conclusions of law insist that the hearing be reconvened for the introduction of the supplementary analyses which were merely recapitulations of evidence already in the record and were being offered as a convenience to petitioners (R. 1102).

March 2, 1964, petitioners filed their proposed findings and brief (R. 1319) and the Division filed its reply brief on March 12, 1964 (R. 1363). This Court on March 30, 1964 dismissed the petition to review. The hearing examiner entered his recommended decision on April 3, 1964 (R. 1375). Exceptions were taken by the Division on April 13, 1964 (R. 1396) and a brief was filed in support thereof on April 23, 1964 (R. 1405). Petitioners sought and were granted an extension of time until June 2, 1964 to file a brief in support of exceptions to the hearing examiner's recommended decision (R. 1414, 1417). Having received no brief by June 10, 1964, the Commission took the proceeding under advisement. On August 27, 1965, the Commission entered the opinion and order from which petitioners now seek review.[13]

## SUMMARY OF ARGUMENT

The Commission correctly found that petitioners, who enjoyed the trust and confidence of their customers, violated their fiduciary obligations to them and the antifraud provisions of the securities laws: (1) by churning their customers' mutual fund accounts; (2) by repeatedly effecting purchases of mutual fund shares for customers just below minimum break points and failing adequately to disclose to customers that they could save money by slightly larger investments so as to take advantage of lower sales charges; and (3) by effecting sales to customers of mutual fund shares at prices above the offering price.[14] These activities, while

[13] On September 17, 1965, the Commission stayed the effectiveness of its order pending the determination of this petition to review (R. 1436).

[14] The last category does not apply to Russell Lawson Irish.

detrimental to the interests of petitioners' customers, resulted in substantially increased commissions for petitioners.

Petitioners seek reversal of the Commission's order on the ground of delay during the proceeding. Petitioners, however, did not attempt to expedite the proceeding and, indeed, have contributed to the delay. Moreover, they have not shown that they have suffered any injury by reason of the delay. Accordingly, petitioners have not shown the requisite elements of laches. In any event, the doctrine of laches is not applicable against the government.

Petitioners' other procedural contentions are also without merit.

## ARGUMENT

### I. The Commission Properly Found That Petitioners Had Violated the Antifraud Provisions of the Securities Laws and Its Decision Is Supported by Substantial Evidence.

#### A. *Excessive Trading in Customers' Accounts.*

Petitioners cannot and do not contend that churning of customers' accounts does not violate the antifraud provisions of the securities laws. This Court has affirmed *per curiam,* "upon grounds and for the reasons stated" by the Commission, a holding of the Commission that churning of customers' accounts violates the antifraud provisions of the securities laws. *Hersh* v. *Securities and Exchange Commission,* 325 F. 2d 147 (1963), *certiorari denied,* 377 U.S. 937 (1964), *affirming J. Logan & Co.,* (Securities Exchange Act Release No. 6848, July 9, 1962). In that case the Commission had pointed to its frequent emphasis that "inherent

in the relationship of every broker-dealer with his customer is the implied vital representation that the customer will be dealt with fairly and honestly." *J. Logan & Co., supra* at p. 10. Similarly, the United States Court of Appeals for the District of Columbia Circuit has specifically held that excessive trading in a customer's account violates the antifraud provisions of the Securities Exchange Act. *Norris & Hirshberg, Inc.* v. *Securities and Exchange Commission,* 177 F. 2d 228, 231-232 (1949). A typical instance of churning was described by the Commission in *R. H. Johnson & Co.,* 36 S.E.C. 467, 485 (1955), *affirmed sub nom. R. H. Johnson & Co.* v. *Securities and Exchange Commission,* 231 F. 2d 523 (C.A. D.C., 1956), *certiorari denied,* 352 U.S. 844 (1956):

> "The customers involved were uninformed or inexperienced in securities matters and generally relied upon the salesman's advice with respect to their securities transactions. Under these circumstances, Sharpe, Woods, Lewis and Quinn occupied a position of trust and confidence with respect to these customers and were under a duty to act in their best interests in effecting transactions in their accounts. Instead, they used that relationship to cause an excessive number of transactions, which frequently involved multiple trading in the same security and switches from one security to another, . . . . It is evident that the salesmen were motivated by the desire to produce income for themselves as well as registrant by inducing an undue number of transactions on which

> commissions and profits could be taken without regard to the interest of the customers and in violation of the fiduciary duty which they owed to them."

See also *Looper and Company,* 38 S.E.C. 294, 300-301 (1958).

Although petitioners appear to argue that their activities do not constitute churning (Br. 28-29), it is clear that the requisite elements of churning under the foregoing authorities have been established: (1) a relationship of trust and confidence between the broker-dealer and his customers giving rise to a duty on his part to act in their best interest; and (2) violation of his fiduciary obligations by the broker-dealer by causing an excessive number of transactions in his customers' accounts resulting in increased commissions.

There can be no doubt that a relationship of trust and confidence existed between Mr. Irish and his customers. The nine customers whose accounts were analyzed herein were not sophisticated investors. They looked to Mr. Irish for guidance in investing in mutual fund shares. They constantly followed his changing recommendations relating to the purchase and sale of mutual fund shares (R. 1423). Indeed, Mr. Irish admitted that he played a very active role as investment adviser (R. 371).

Nor can there be any doubt that Mr. Irish took advantage of the relationship of trust and confidence which obtained with his customers to cause an excessive number of transactions in their accounts to their detri-

ment and to his own advantage.[15] The hearing examiner and the Commission could and did properly assume that the great number of switches in the customers' accounts (see pages 4-6, *supra*) were motivated by petitioners' desire to increase their commissions.

Two factors peculiar to mutual funds make excessive trading therein even more damaging to customers than excessive trading in other securities. First, the high sales commissions skim off around 9% of the money invested at the time the purchase is effected. Second, the funds themselves, generally speaking, are broadly diversified and their management and investment advisory firms constantly supervise the fund portfolio

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[15] "Switching" an investor from one mutual fund (open-end investment company) to another as a means of obtaining increased commissions is an abuse which is facilitated by the redemption feature of mutual funds. This was spelled out in the Commission's report on investment companies which led to the passage of the Investment Company Act of 1940, 15 U.S.C. 80-1a, *et seq.*, as follows:

> "The nature of open-end companies and fixed-trusts, particularly their obligation to redeem their shares or certificates at asset value, has made their securities vulnerable to 'switching' operations, i.e., attempts by dealers to persuade customers to sell the shares of one investment company and to use the proceeds to buy those of another. Distributors, dealers, and salesmen, profited from each sale of an investment company issue, whether the sale involved the investment of additional funds by a customer or merely his liquidation of one issue to buy another. Such operations may, however, be costly to investors since they involve the payment of a new load on each shift.
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> "The prevalence of switching of open-end company shares or fixed-trust certificates is attributable to the ability of the dealer readily to liquidate the shares or certificates taken in payment for those of the new company or trust because of the rights of redemption." *Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission*, Part Two, Chapter III, page 221 (1940).

to determine what investments are most appropriate. Even Mr. Irish acknowledged the importance of management in mutual funds (R. 368-369). The Commission in *Thomas Arthur Stewart*, 20 S.E.C. 196, 201-202 (1945), noted that the above two factors made the switching of mutual funds inherently unprofitable except under very unusual circumstances, and, of course, except from the broker-dealer's own personal point of view, stating:

> "In view of the selling load included in the purchase price, in-and-out trading in the subject shares could be profitable only (a) if the purchase were followed by a market appreciation of the portfolio or an increase in the fund's net current assets *sufficient to exceed the selling load of 8 percent to 9½ percent,* or (b) if a redemption were followed by an equivalent recession and subsequent repurchase. *In switches from one trust to another in simultaneous purchases and redemptions, the very diversification of the trust portfolios decreased the likelihood that any marketwise benefit would be gained by the customers, since they were continuously in the market, yet repeatedly paying substantial selling loads.* Increased activity in the customers' accounts increased Stewart's commissions but decreased the customers' chances for profit." (Second emphasis added.)

Not surprisingly, the record establishes in the instant case that results for each of the nine customers whose

accounts were analyzed would have been substantially better if the switching had not occurred (pages 4-6, *supra*). From the standpoint of petitioners' commissions, however, the record showed that during the five-year period under analysis commissions paid by the nine customers and attributable to churning amounted to $66,593, or over 50% of all commissions collected from these nine accounts (R. 1424).

Petitioners contend (Br. 28-29) that their churning activities did not violate the antifraud provisions because no secret profits or discretionary accounts were involved. In support thereof they cite (Br. 29) *Behel, Johnsen & Co.,* 26 S.E.C. 163 (1947). While secret profits were involved in that case, the Commission expressly noted " 'Churning' may occur where a firm confirms as agent and discloses its commissions." 26 S.E.C. at 168. Petitioners (Br. 29) also cite *Thomson & McKinnon,* 35 S.E.C. 451 (1953), in which the Commission recognized that where a customer initiates his own trading, the broker has not violated the antifraud provisions. The facts of the instant case show that petitioners' customers heeded and followed petitioners' advice and that the switching of the funds' shares in the customers' accounts originated with petitioners and not with the customers (R. 49, 57, 59, 152, 198, 485).

Petitioners also contend that no churning violations occurred because customers were furnished with confirmations "which stated that the costs of any exchange of securities should always be weighed by the customer" (Br. 29). The illegal transactions took place over the period 1953 through 1958 and the confirmations to

which petitioners refer were not employed until November 11, 1955.[16] In any event, such an after-the-fact statement in a confirmation is not the type of disclosure which would have to be made to enable the customer to make an informed judgment; it would tend to be disregarded in the face of petitioners' affirmative recommendations to sell and purchase. Petitioners cannot defraud their customers and then rely for exculpation upon their customers' failure to object. As the Commission stated in *Shearson, Hammill & Co.*, (Securities Exchange Act Release No. 7743, November 12, 1965) at p. 31:

> "the responsibility for refraining from excessive trading, which even if each transaction shows a profit, will deplete the account or reduce the overall profit that might otherwise be made because of the commission paid on each transaction, cannot properly be avoided by pointing to the failure of an unsophisticated customer to object."

B. *Sales Below Break Points.*

With respect to petitioners' failure adequately to disclose to customers that they could save money by slightly larger investments so as to take advantage of lower sales charges, there also can be no doubt that petitioners violated their fiduciary obligations and the antifraud provisions. The Commission has pointed out in a case involving a broker-dealer who sold mutual fund shares to an order of nuns in amounts slightly

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[16] Mr. Irish stated that he began using the rubber stamp "warning" legend on about that date, and that he did so because of his NASD difficulties (R. 314-316).

below break points, that a broker-dealer's fiduciary duty is to make adequate advance disclosure of the break points, and this duty is not satisfied by merely furnishing the customer with a prospectus describing them. *Mason, Moran & Co.,* 35 S.E.C. 84, 90 (1953).[17] Further, as Mr. Irish has stated, he, in effect, acted as an investment adviser for his customers (R. 371). The Supreme Court has noted, in describing the fiduciary obligations of an investment adviser: "Courts have imposed on a fiduciary an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading' his clients." *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc.,* 375 U.S. 180, 194, (1963).

Petitioners contest (Br. 29-30) the Commission's findings (R. 1427) that they did not adequately disclose minimum break points to their customers. They state (Br. 29) that customers testified "they were always advised of break points and even their attention was called to the statements on confirmations (Tr. 1-469; 874-916; 917-918)."

The Commission found, however, in none of the situations where there were break point violations did it appear that adequate disclosure had been made prior to the transaction (R. 1427). Harry N. Boger testified that he did not even learn the meaning of the term

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[17] As the Commission there suggested, since the portfolios were already diversified, it is unlikely that the customers were caused to invest in two funds for purposes of greater diversification of their investments, rather than to obtain increased commissions for the broker-dealer. *Ibid.*

"break point" until 1954 (R. 254), over a year after the first break point violation to which he was subjected (see page 7, *supra*). Russell Lawson Irish was asked whether he ever discussed with Mr. Prince "the desirability of combining the purchases into a single fund in order to have a break point advantage" and replied "No, not at that time as far as my memory recalls" (R. 164). Russell Lawson Irish further testified that he had not discussed this possibility with Mr. Prince even when he had recommended on two consecutive days in May 1954 that Mr. Prince purchase $12,000 in one fund and $17,000 in another (R. 165). As to the statement on the confirmations, this related to switching, not break points, and was, as noted above, not employed until after November 11, 1955, after all the break point violations charges had occurred (R. 314-316).

C. *Sales at Prices Above Offering Price.*

The facts involved in these two violations occurring in 1954 are described at page 8 of this brief. Petitioners' brief asserts that these failures to obtain reduced sales charges and consequent increased commissions were "the result of an error caused by the mutual fund in its offices in New York City" (Br. 30). Again the record is to the contrary. An employee of Distributor's Group, Inc., which is the sponsor and manager of Group Securities, Inc., the fund to which petitioners refer, testified that when the orders were received he called petitioners and was expressly told that the orders were not single orders and were not to be combined to achieve lower break point advantages (R. 539-541).

Mr. Irish also attempted to explain his failure to combine the funds on the ground that he did not know that two series of the same fund could be combined. But the prospectus for that fund stated that they could (R. 53-56, 343-345). And the record shows that shares of the Group Securities Series were among those most frequently sold by Mr. Irish (R. 918-934).

## II. Petitioners' Procedural Arguments Are Without Merit

### A. *The Delay in the Proceeding Constitutes no Ground for Reversal.*

Petitioners seek reversal of the Commission's order on the ground that the lapse of time in the proceeding has been inexcusable and has resulted in prejudice to them (Br. 17-18). As we have shown (pp. 10-14, *supra*), however, petitioners have contributed to the lapse of time in the proceeding, have never attempted to expedite the proceeding and have not shown that they have suffered any injury.

Petitioners did not move to dismiss until the Commission's staff sought to schedule the filing of proposed findings and conclusions. Indeed, when the Commission's staff sought to conclude the proceeding, counsel for petitioners claimed that this action was taken "suddenly, arbitrarily and capriciously" (R. 1345).

Under these circumstances, neither due process nor any provision of the Administrative Procedure Act authorizes dismissal of the proceeding on the ground of delay. Compare *National Labor Relations Board* v.

*Pool Mfg. Co.,* 339 U.S. 577, 581 (1950), where the Supreme Court, considering the question of a two and one-half year delay of the NLRB to enforce one of its orders, cited this Court's opinion in *National Labor Relations Board* v. *Andrew Jergens Co.,* 175 F. 2d 130, 134 (1949), and stated: "The employer, who could have obtained review of the Board's order when it was entered, § 10(f), is hardly in a position to object."

The very cases cited by petitioners on page 22 of their brief hold that the doctrine of laches is not applicable to the government. Mr. Justice Stone in *Guaranty Trust Co. of New York* v. *United States,* 304 U.S. 126, 132 (1938), stated the rationale of the rule of non-application as follows:

> "Regardless of the form of government and independently of the royal prerogative once thought sufficient to justify it, the rule is supportable now because its benefit and advantage extend to every citizen, including the defendant whose pleas of laches or limitation it precludes; and its uniform survival in the United States has generally been accounted for and justified on grounds of policy rather than upon any inherited notions of the personal privilege of the king."

The doctrine of laches has been held to be inapplicable in numerous cases in which the government, as here, has instituted an action in its sovereign capacity to protect the public interest. See, *e.g., Utah Power and Light Co.* v. *United States* 243 U.S. 389, 409 (1917) (action to enjoin private use of public lands); *United States* v. *Brass,* 37 F. Supp. 698, 699 (E.D. N.Y., 1941)

(action to vacate certificate of naturalization); *Sims Motor Transport Lines, Inc.* v. *United States,* 183 F. Supp. 113 (N.D. Ill., 1959), *aff'd per curiam* 362 U.S. 637 (1960) (action to set aside ICC cease and desist order). It has, further, been explicitly held that the doctrine of estoppel, which includes laches, cannot be invoked against an administrative agency. *Securities and Exchange Commission* v. *Morgan, Lewis & Bockius,* 209 F. 2d 44, 49 (C.A. 3, 1953).[18]

Even assuming arguendo that the doctrine of laches were applicable, it would be necessary for petitioners to show "inexcusable delay" and "non-action . . . operat[ing] to damage the defendant or to induce it to change its position," *Northern Pacific Ry Co.* v. *Boyd,* 228 U.S. 482, 509 (1913). Contrary to petitioners' contention (Br. 18), "there is no neces-

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[18] Petitioners assert (Br. 21) that "cases carefully distinguish circumstances under which the government has not received any rights or where its actions are void and the rule is carefully so limited," citing *Guaranty Trust* v. *United States,* 304 U.S. 126, *supra,* at 135, 141; *Utah Power & Light Co.* v. *United States,* 243 U.S. 389, *supra* at 409; *Causey* v. *United States,* 240 U.S. 399, 402 (1916); and *Chesapeake & Delaware Canal Co.* v. *United States,* 250 U.S. 123, 126 (1919). A reading of these cases shows no distinction. In *Steen* v. *Los Angeles,* 190 P. 2d 937 (1948), a suit against the City of Los Angeles, the court did not dismiss the action. *Major* v. *Shaver,* 187 F. 2d 211 (C.A. D.C., 1951), is not a case in which the government was a party.

Petitioners also contend (Br. 26) that "federal courts have viewed the lack of due process because of administrative irregularities and delay . . . with sufficient gravity that the courts have held there is no absolute requirement that a party exhaust his administrative remedies . . .", citing *Adler* v. *United States,* 146 F. Supp. 956 (Ct. of Cl., 1956), *certiorari denied, sub nom. Baker* v. *United States,* 352 U.S. 894 (1956). That case involved no question of delay and held that discharged federal employees must exhaust their administrative remedies before seeking the aid of a federal court.

sary estoppel arising from the mere lapse of time." *Ibid.* See also *Costello* v. *United States,* 365 U.S. 265, 282 (1961); *McConville* v. *Florida Towing Corporation,* 321 F. 2d 162, 168 (C.A. 5, 1963).[19]

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[19] The cases cited by petitioners (Br. 18) in support of the statement that mere lapse of time voids the proceeding and constitutes a violation of due process of law are not in point. In *Smith* v. *Illinois Bell Telephone Co.,* 270 U.S. 587, 591 (1926), the utility showed specific injury flowing from the inaction of the regulatory body in that it was forced to keep its old and inadequate rates in effect.

*Deering Milliken, Inc.* v. *Johnston,* 295 F. 2d 856 (C.A. 4, 1961), involves the question whether a federal agency (the National Labor Relations Board) may be enjoined on the basis of Section 10(e) of the Administrative Procedure Act from conducting lengthy hearings covering ground covered in a prior hearing. *Swift & Co.* v. *United States,* 308 F. 2d 849 (C.A. 7, 1962), does not involve any question of delay in administrative proceedings but only the question of whether due process is violated by a hearing examiner's admission of certain evidence into an administrative proceeding. *Amos Treat & Co.* v. *Securities and Exchange Commission,* 306 F. 2d 260 (C.A. D.C., 1962), involves the question whether this Commission may be enjoined from continuing a proceeding instituted at a time when one of the Commissioners had been director of one of the operating divisions.

*Kessler* v. *Federal Communications Commission,* 326 F. 2d 673 (C.A. D.C., 1963), again involve no question of administrative delay but whether a "freeze" order of the FCC was valid.

*Lasdon* v. *Hallihan,* 36 N.E. 2d 227 (1941), among the cases cited by petitioners as establishing that the right to conduct a business is a property right (Br. 18), also shows that a government agency may regulate business practices. *Rosenblum* v. *Rosenblum,* 42 N.Y. S. 2d 626 (1943), to the effect that everyone is entitled to his day in Court, does not support petitioners' statement (Br. 18) that they have not "been accorded orderly process" and "granted only inordinate delays." That case involved the question whether during the second World War a husband in a divorce action in New York could serve his wife by publication while she was residing in occupied France.

### B. *The Commission Correctly Concluded that Petitioners Were Not Entitled to a Presumption of Good Conduct since 1959.*

In disagreeing with the hearing examiner as to the weight given by him to the delay in the proceeding, the Commission found that petitioners were not entitled to a presumption of good conduct since 1959 when the hearings were closed in view of the absence of evidence in the record on this point (R. 1428-1429).[20] Petitioners contend (Br. 19) that under "any rationale of due process" they were entitled to this presumption. The Commission found that no such presumption was warranted in light of the violations found and in view of the fact (see pages 9-10, *supra*) that Mr. Irish had continued his switching activities (in the accounts, among others, of some of the nine customers involved in the instant proceeding) after the NASD in 1955 had suspended him from membership for 15 days and fined him $3,000 for such activities.

Petitioners contend (Br. 19-20) that the Commission "callously and with cynical disregard" of petitioners' rights "ignored that presently pending before it" at the time it entered the order under review was an appeal by petitioners from another decision of the NASD relating to their activities for the years 1956-1962. Petitioners suggest that the Commission has acted

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[20] *Wesreb Oil Co.*, (Securities Act Release No. 4647, September 30, 1963); *Howard F. Hansell, Jr.*, 31 S.E.C. 393 (1950); *Herbert A. Mendell*, 31 S.E.C. 491 (1950), cited by petitioners (Br. 19), are not in point. In those cases, the record affirmatively showed that the respondents therein had conducted themselves in a proper manner subsequent to the entry of injunctions against them.

in an inconsistent manner because "*identical* commissioners" found that revocation of Mr. Irish's registration in the instant case was required by the public interest and found that in the NASD appeal the public interest required that the penalties assessed by the NASD should be reduced to censure and nominal costs (Br. 20).[21]

This is not what occurred. The NASD's District Committee found that petitioners had violated the extension of credit provisions of Regulation T under the Securities Exchange Act. At the same time the District Committee dismissed a complaint that petitioners had churned the accounts of their customers. Upon review the NASD's Board of Governors affirmed the District Committee's determination that petitioners had violated Regulation T and reversed the District Committee and reinstated the charge that accounts had been churned. Upon review, the Commission disagreed with several of the findings of the Board of Governors and of the District Committee with respect to the violations of Regulation T and reduced the penalty. *The Commission further found that the Board of Governors had erred in reinstating (more than 30 days after dismissal by the NASD's District Committee) the charge of churning because, under the NASD's rules such reinstatement could only have been made within 30 days after such dismissal.* Accordingly, the Commission held that the Board could not consider this charge.

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[21] *Russell L. Irish,* (Securities Exchange Act Release No. 7718, October 5, 1965). The Commission also held that sanctions and costs against Russell Lawson Irish should be cancelled.

There is thus no inconsistency between the Commission's decision under review here based on petitioners' churning activities and its holding on review of the NASD's decision that the charge of churning made there was not properly before its Board.

### C. *The Proceeding Was Conducted in Accordance with the Commission's Rules of Practice.*

Petitioners further attack the Commission's decision on the ground that the proceedings were conducted in violation of the Commission's Rules of Practice. Specifically, petitioners contend that Rules 13, 16(e) and 19 of the Commission's Rules of Practice, 17 CFR 201.13, 16(e) and 19, were violated (Br. 23, 25, 27-28). The rules cited by petitioners are either not applicable to this proceeding or, if applicable, were not violated.

*Rule 13.*

Rule 13(c) of the Commission's Rules of Practice provides in part that a "convened hearing may be adjourned to such time and place as may be ordered by the Commission or by the hearing officer. It is the policy of the Commission that such adjournments shall be for not more than 30 days and in no event shall a hearing officer order an adjournment for a period in excess of 45 days." The applicability of Rule 13 to these proceedings was considered by the Commission at the time it denied petitioner's motion to dismiss the proceeding (see page 10, *supra*). The Commission held that Rule 13 did not apply because it "was not adopted by the Commission until after the hearing was

closed in 1959 subject to the filing of depositions, and no adjournment was ordered by the hearing examiner following the filing of the last deposition in April 1961, when such limitation was in effect" (R. 1162).[22]

*Rule 16(e).*

Petitioners' reliance on Rule 16(e) of the Rules of Practice is also misplaced. Rule 16(e) directs, "At the end of every hearing, the hearing officer shall, after consultation with the parties, provide the period within which . . . proposed findings and conclusions and supporting briefs are to be filed . . ., provided, however, that the period within which the first filing is to be made normally should be no more than 30 days, and shall not exceed 60 days, after the close of the hearing." Like Rule 13, Rule 16(e) did not become effective until October 1, 1960, after the hearings had been closed.[23] When Rule 16(e) was in effect, at the time the depositions were made a part of the record, petitioners did not request the hearing examiner to schedule the filing of proposed findings and conclusions.

*Rule 19(e).*

Petitioners also rely upon Rule 19(e) (Br. 27-28), but this rule is applicable only in the case of orders temporarily suspending a broker-dealer registration pending decision on whether permanent revocation should be ordered. No such temporary suspension

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[22] Rule 13 was adopted as part of a general revision of the Commission's Rules of Practice and did not become effective until October 1, 1960, 25 Fed. Reg. 6719, 6732 (1960).

[23] 25 Fed. Reg. 6719, 6733 (1960).

proceeding was involved here. See Section 15(b)(6) of the Securities Exchange Act, 15 U.S.C. 78*o*(b)(6).

### D. *The Commission Did Not Err in Considering Violations Over a Substantial Period of Time.*

Petitioners argue that the Commission's decision was based upon "improperly admitted records" and evidence "that included testimony and exhibits pertaining in time as much as 18 years prior in time to the date of the 1959 hearings, well beyond the maximum three and six years required by the Respondent's own rules for holding books and records by . . . [petitioners]" (Br. 28, 31). Petitioners thus suggest that the Commission decided this case on evidence going back as far as 1941 and they argue that the Commission may not properly inquire into violations occurring more than six years prior to the date of a hearing (Br. 25-26, 31).

The Commission's opinion makes clear that the earliest violation it considered was in 1950 not 1941. In connection with petitioners' switching activities, it considered only evidence for the years 1953-1958 (R. 1422). With respect to the Commission's finding that Mr. Irish had sold mutual fund above the offering price, two transactions in 1954 were considered (R. 1426). Only in the case of petitioners' failure to advise customers of minimum break points did the Commission go back beyond 1953. While it found break point violations in the years 1954 and 1955, it also found them in 1950, 1951 and 1952 (R. 1427). Accordingly, the argument that the Commission can go back only six years, even if valid, would only apply to certain break point

violations and to none of the other violations found by the Commission.

In any event, petitioners' argument erroneously presupposes that the period of inquiry into violations of the securities laws by a broker-dealer in an administrative proceeding is governed by a bookkeeping rule, Rule 17a-4, 17 CFR 240.17a-4, which requires that a broker and dealer shall keep certain records for a period of "not less than 6 years." This rule does not purport to be and has never been interpreted as a limitation on actions by the Commission. As counsel for petitioners correctly conceded during the course of the hearings, "there is no true civil statute of limitations as to the Commission's right to act against . . . broker dealers . . . ." (Br. 13.) Petitioners' argument concerning a limitation on actions appears to be based on the misconception that these proceedings are penal. This Court rejected a similar argument in *Pierce v. Securities and Exchange Commission,* 239 F. 2d 160, 163 (1956), stating:

> "In our view, petitioner misinterprets the purpose of the broker-dealer registration law here involved. Denial of registration is not to be regarded as a penalty imposed on the broker. To the contrary, it is but a means to protect the public interest."

E. *Petitioners' Other Defenses Are Untenable.*

Petitioners also argue (Br. 32) that they were prejudiced by the staff's request on May 27, 1959, to inspect their books and records on the ground that such request was for an "unbridled investigation or 'fishing expedition' into an adversary's books and records . . . ." While the staff request was well within the scope of Section 17(a) of the Securities Exchange Act, 15 U.S.C. 78q(a), it is not necessary for this question to be considered since petitioners did not comply with the staff's request. Since no findings of violation were proposed or based thereon, petitioners could not have been prejudiced.

Petitioners further suggest (Br. 28-29) that they did not violate the antifraud provisions because "[n]o customers ever launched a complaint nor had the . . . [petitioners] lost any of their customers." The fact that petitioners' customers may not have appreciated that they were being defrauded is no reason why petitioners should be continued in business. The securities laws are designed, *inter alia,* to protect "those who lack business acumen,"[24] or persons who have been described as "the investing and usually naive public."[25]

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[24] *United States* v. *Monjar,* 47 F. Supp. 421, 425 (D.Del., 1942) *aff'd* 147 F. 2d 916 (C.A. 3, 1945), *certiorari denied,* 325 U.S. 859 (1945).

[25] *Norris & Hirshberg, Inc.* v. *Securities and Exchange Commission,* 177 F. 2d 228, 233 (C.A. D.C., 1949).

## CONCLUSION

For the foregoing reasons the petition for review should be denied.

Respectfully submitted,

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Dated: July, 1966.

## CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit and that, in my opinion, the foregoing brief is in full compliance with those rules.

/s/ David Ferber,
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